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CURRENCIES AND CREDIT MARKETS

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"We are not through the difficulties of our situation, but I am convinced we have passed the worst and with continued effort we shall rapidly recover."

President Herbert Hoover
May 1, 1930

HIGHLIGHTS

The prospect of a currency and economic unification between West and East Germany has been the scapegoat for the recent shock waves reverberating throughout the world's currency and financial markets. But can a mere 16 million poor people be the cause of all this fuss for the rest of the world's wealthy populations?

Fears that a currency unification will set off significantly higher inflation and ballooning budget deficits in West Germany are more fear than fact.

Even if we are too optimistic on the inflationary and budget deficit implications of a German unification it won't be negative for the D-mark. On the contrary, the policy-mix of a tight money and fiscal expansion is the surest prescription for an appreciation in the D-mark.

The most important lesson of the 1980s was that the impact of a budget deficit on a country's inflation and currency depended first on the underlying monetary policy and not on the deficit's size. Fiscal expansion in conjunction with a lax monetary policy - meaning the monetization of the deficit - was the disastrous policy-mix of the 1970s.

The entirety of East European events means that the clamour for limited world savings will heighten and maintain firm pressure on world interest rates. Yet markets would have us believe that such conditions will be rougher on those countries with savings surpluses than those lumbered with inadequate savings. To believe that is total economic illiteracy.

For the U.S., the trends are absolutely clear. Given demand weakness in almost every sector, a profit squeeze, record low credit expansion, and serious financial strains, the dangers of wide-spread complacency are increasing. The economy is indeed hovering on the brink of recession, and the risks for a prolonged down-turn are the highest of the entire post-war period.

In Japan, more and more it seems to us that developments are fast careening out of control. The hesitancy and ambiguity of the central bank has contributed to a loss of confidence and the longer it hesitates, the higher the necessary rise in interest rates. In the end, only "hara-kiri" may satisfy the international markets.

BETWEEN THREE CORNERS: GERMAN MONETARY UNIFICATION, AMERICAN STATISTICAL HOCUS-POCUS, AND JAPANESE HARI-KARI

Three big questions are keeping the world's currency and financial markets in suspense presently:

1. What are the implications of German currency unification?
2. Has the U.S. economy really bottomed out as markets seem to have assumed?
3. What in the world is happening in Japan?

To start with, the prospect of currency unification between West and East Germany has sent shock waves throughout the world's currency and financial markets. The recent upheavals in these markets found an easy scapegoat. To quote a recent front-page article in the New York Times: *"Central factor is the sudden inflationary fears abroad, primarily in Germany"*. It must be flattering for the poor 16 million East Germans to think that they could immediately give the world's markets such jitters. Frankly, we wonder whether events in Germany might only have been a trigger to these market turmoils rather than their actual cause.

Supposedly, there are two German-related worries haunting markets. One fear is that currency unification will set off significantly higher inflation in West Germany, eventually forcing the Bundesbank to drastically tighten its reins. The other fear is that German and international capital markets will be hit by an exploding budget deficit as the West German government finances the modernization of East Germany's desolate infrastructure and assumes soaring welfare obligations.

Already, on the back of these fears, German long-term interest rates have soared to levels that have not been seen since 1982 when inflation was over 6%. Markets cannot stand uncertainty. The problems that an East-West German monetary unification involve seem too complex and difficult to grasp. Yet, it's easy to see that both fears - those of inflation as well as a soaring budget deficit - are ridiculously exaggerated. The numbers and arguments that have been brought forward in that regard, are outright nonsense. It appears to us that the skid of German Bunds has more to do with aggressive speculation than with genuine investor anxiety. Actually, there has been very little trading in the bond themselves, but there's been huge business in the highly speculative London futures market.

One argument plays a key role in substantiating German inflation fears. It concerns the impact of 170 billion ostmarks in accumulated savings (with a further cash circulation of 16 billion) and the rate at which they will be converted into D-marks. It is usually argued that the build-up of these savings was the result of there being too few goods to buy. The fear is that once converted into hard D-marks, and the closer the conversion rate to 1:1, the greater the potential for spending. More than anything else, it was the idea of a one-to-one swap that shattered the German bond market.

In the first place, what most observers overlook in their hysteria is that the conversion rate and the pace of conversion will be two different things. Even if a one-to-one rate is chosen for political reasons, there are many ways to freeze or mop up excess liquidity and thereby keep the inflationary impact on West Germany to modest proportions.

THE D-MARK: SOME FEARS COULD ACTUALLY BE POSITIVE

For arguments sake, let's assume that we are too optimistic and that present market fears

about West German inflation and vast government borrowing needs are more justified that we think. How would that impact the D-Mark and the German bond market?

In short, we think the impact would be drastically different from what most people seem to believe. Apparently, the dominating view is that expected events should depress both bonds and the currency. In fact, that's been the spontaneous market response. We think that opinion is wrong. A ballooning budget deficit and rising interest rates when coupled with a monetary squeeze couldn't be a more bullish prescription for the D-mark. While few Europeans seem to understand that reasoning, many North Americans do. Such a policy mix would be the exact pattern of the Reagan experience.

The most important lesson of the 1980s has been that the impact of a budget deficit on a country's inflation and currency depends on the underlying monetary policy and not on the deficit's size. Fiscal expansion in conjunction with a lax monetary policy - meaning the monetization of the deficit - was the typical policy mix of the 1970s. Undoubtedly, that mix results in an inflationary overheating, a weak bond market and a weak currency.

However, the scenario to envisage for Germany would be a fiscal expansion with tight money. What would the Bundesbank do if, sooner or later, it were confronted with soaring government needs and accelerating inflation? Without a doubt, the bank would quickly and rigorously respond with a drastic monetary squeeze thus driving up interest rates. It goes without saying what the first and immediate effect of this measure would then be: it would pull in floods of foreign capital sending the D-Mark skyward - actually, higher than would we the case with lower inflation and a smaller budget deficit.

Taking Their Own Prescription. It was precisely this new and perverse policy mix - fiscal laxity coupled with monetary stringency - with which the United States, Canada and many other countries have buoyed their currencies in past years, even though they were running huge trade and current-account deficits. Just imagine how this medicine may work in the case of West Germany where this policy could even be complemented by a large trade surplus.

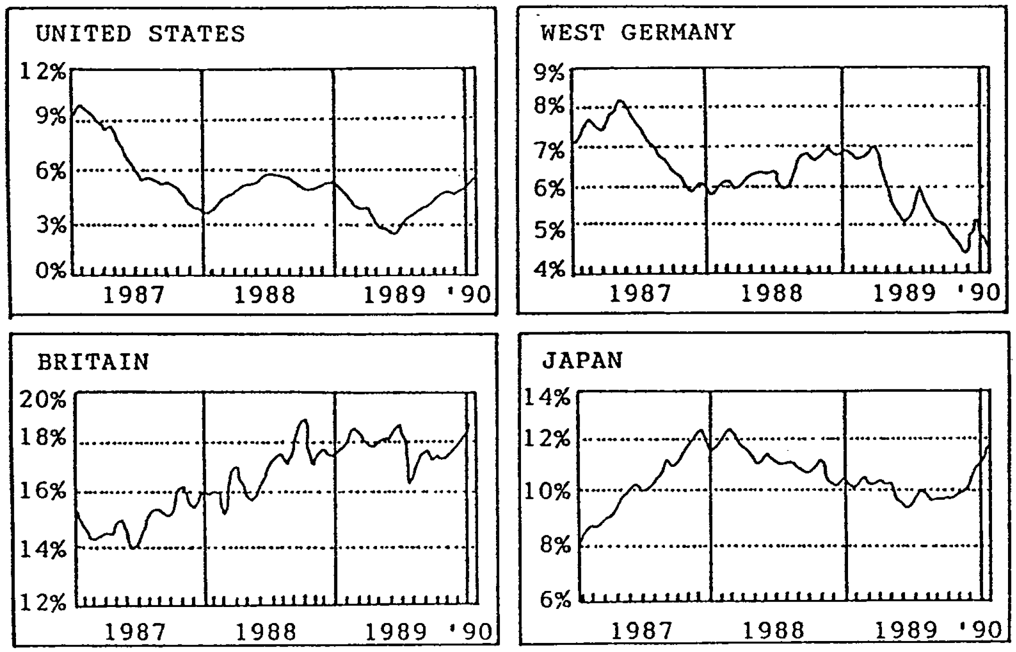
Even if we are too optimistic on the inflationary and budget deficit implications of a German unification, if nothing else, it won't be as negative for the D-mark as markets seem to believe.

Dispelling the Inflation Paradox. International bond traders seem to think that the Bundesbank ought to respond to their hysterical reactions to currency unification by raising interest rates. A reflection of this sentiment is apparent in the following Financial Times quote: *The recent behaviour of the German and the Japanese authorities suggest strongly that they do not care about inflation and inflationary expectations.*"

As so often is the case, stupidity and arrogance seem to go together. The fact is that of all the major countries, Germany by far, has the lowest inflation rate and the tightest monetary policy. Apart from bond trader's hysteria, there is absolutely no reason to tighten further. If there's any reason for the Bundesbank to tighten it would be a D-Mark that is too weak and not Germany's comparative inflation performance.

A quick comparison is in order to prove our point. First, let's look at the development of the broad money supply in the United States, Germany, Britain and Japan. The following charts hardly need comment.

MAJOR INDUSTRIAL ECONOMIES . . year-to-year change in broad money supply.



Next, what about actual inflation trends as measured by the CPI? Again, West Germany has the most favourable result. But, U.S. economists like to look at the core inflation rate without food and energy prices. On those terms, what are the relevant numbers for Germany? Over the last six months industrial prices (seasonally adjusted) rose at an annual rate of 1.6% with energy included and at 1.0% without. On the same basis, consumer prices rose at an annual rate of 2.0% inclusive of food and energy and 1.7% without. Quite simply, to have countries with inflation rates of 2-3 times higher lecture such a good performance record is really an unbelievable arrogance.

CONSUMER PRICES
(% change at annual rate)

	3 mths	1 year
United State	4.6	5.2
Germany	2.1	2.7
Britain	8.1	7.7
Japan	2.6	2.6

Germany, by far, also has the highest interest rates after adjusting for inflation. Long-term real yield comparisons are as follows: United States, 3.3%; Germany, 6-7%; Britain, 3%; and Japan, 4.4%.

Future German Inflation Trends? But what is inflation in Germany likely to be over the medium-term if the monetary unification takes place? Our view is that any upward shift in the underlying inflation rate will be moderate and will not rise much above 3%, if at all. Though capacity utilization is at the highest recorded level since 1971-72, there are other strong influences that should contain inflation. Energy and raw material prices have benefited from the recent strength of the D-Mark against the dollar. Unit wage costs were virtually flat throughout 1988 and 1989 as productivity gains accelerated to 3%. Wages will catch up,

but surging investment and buoyant output suggest that productivity growth will continue at its high rate.

Now compare the foregoing with the example of the United States. Despite a strong dollar and two years of relatively tight money, absolutely no progress has been made towards lower inflation. On the contrary, inflation has accelerated to a year-over-year rate of 5.2%.

Mr. Greenspan's efforts have failed, and will continue to be futile because his tight money policy fights an inflation that finds its root in a low investment and dismal productivity performance. That mix of conditions transmit a strong inflation bias through upward pressure on unit labour costs. Non-farm productivity rose at a scant rate of 0.2% (annualized) in the final quarter of 1989. Productivity growth from the fourth quarter of 1988 to the end of 1989 was only 0.6%. However, wages and benefits increased 5.7% resulting in the largest rise in labour unit costs in seven years. What's worse yet, however, is that there has been no increase in real wages.

Comparing Germany's and America's inflation picture, one can only wonder about market sentiment. On top of the obvious comparisons we've made, one must also realize that even with its low 2.6% inflation rate, Germany is sustaining a booming economy, strong profits and a large external surplus while America has a sluggish economy, flagging profits and a large deficit.

CURRENCY UNION: GAUGING THE INFLATION RISKS.

All these discussions still leaves us with the question of the inflation risks inherent in German currency unification. The general hysteria and misconceptions about this issue are really quite ridiculous. We are confident that East-West German monetary and economic reunification can and will be managed without serious inflationary implications. Even if the politicians are a bit too generous with the conversion rate for savings, there are numerous ways of neutralizing the undesirable effects of East German liquidity.

One idea is to sell off East German government assets (houses, flats, shares of new companies etc.) to residents at favourable prices thus also helping to stop East Germans from leaving the country. Part of the savings would then be frozen in assets for a certain period. Another part would go into accelerating imports. And last and not least, a population that is highly uncertain about its future will probably tend to keep a good part of the money as voluntary savings.

There are many potential influences and possible measures that could keep the potential demand impact of monetary union within narrow limits. West Germany's own currency reform in 1948 serves as a good illustration of two other means that served to restrict the conversion of savings and money in circulation. Firstly, conversion was limited to residents and to those accounts that had existed at a certain earlier date. Secondly, cash conversion would be a limited to a fixed amount per head. In the end, a considerable amount of money may not be converted at all. For this reason, we can only warn against the strategy of buying ostmarks in the hope of being able to exchange it one-for-one against D-Mark. The money will be lost.

Inflation Risks Overblown. Concluding, we again want to emphasize that worries about impending inflation in Germany are unfounded. Certainly, currency unification is a complex problem, but it is a manageable one none-the-less. The decisive part of the unification will

centre in a comprehensive package of measures that complements the currency conversion in order to create the pre-conditions for self-propelling growth, just as unfolded after the currency reform of 1948.

This time, though, there is a big brother, West Germany, who brings tremendous assets to the task: a strong currency, the biggest trade surplus in the world, a vast pool of surplus savings to draw upon, as well as technical and managerial know-how.

Monetary Union Not a Cart Before the Horse. While staging the currency reform at the start of an economic merger, rather than nearer the end, has surprised and shocked many experts, on second thought, most have now changed their minds. After all, how, could there be a sound economic upswing on the basis of valueless ostmarks? It is essential that a monetary and financial groundwork should be laid first. In hindsight, many, if not most, German economists have come to realize this. None-the-less, they still take a critical view of the conditions of monetary reform.

Along with inflationary concerns, the other implication of German monetary unification that worries the Bund markets in particular, is the potential impact on the budget deficit. In this respect too, there have been some over-reactions that have unnerved the bond market, judging from the wild estimates that run into fantastical multi-billion sums.

The Real Government Budget. There are two budget-related scare stories in the markets: one, that currency and economic reforms in East Germany will initially cause large-scale mass unemployment; and second, that all East Germans are entitled to the same social welfare net as West Germans. Together - so the conclusion goes - will cost West Germany hundreds of billions of D-Mark. One calculation, for example, maintains that since West Germany now spends DM 1,000 billion ($583 billion U.S) on public services for its 62 million inhabitants, that an additional 17 million East Germans would increase the bill by another DM 200 billion annually.

The logic of this calculation carries some serious flaws. First of all, it wrongly equates a one-to-one conversion of savings with a similar conversion of wages and old-age pensions. East Germany's nominal wage level is far below that of West Germany and will in the meantime have to be kept lower because of lower productivity.

There is one thing that makes lower wages possible: a drastic differences in rents. East German families pay monthly rents for their government-owned housing of between 30-60 ostmarks on average. West Germans pay about twenty times as much, although for much better accommodations. Of course, nobody would tamper with these low rents because they facilitate and justify the wage differentiation that the gross disparity in productivity demands. A continuation of relatively low wages, in turn, keeps service prices low. Clearly, these conditions then also allow a similar lid on old-age pensions. As such, we see no reason to fear an explosion of public expenditures.

Equally misplaced, we think, are the scare stories about expected mass unemployment in East Germany. Here we must distinguish between two sectors: the industrial sector that will be exposed to international competition and the local service sector, both public and private. The brunt of adjustment will fall on industry which employs some 3 million workers, or some 40% of the labour force. Services, however, are not prone to serious disruptions since they are all locally-oriented. Therefore, to speak of a virtual collapse of the East German economy and to predict colossal support payments from West Germany is grossly misguided.

What we find to be the most astonishingly thing, however, is that the scaremongers completely ignore the economic dynamism that would be released by the conditions of stable money together with the freeing of private initiative and market forces. Isn't it plausible that West German service industries would race over to seize low-cost labour opportunities and in so doing, stimulate employment? Investment capital from all over the whole world - earmarked for productive facilities - will be attracted. Local residents will stay put as they see new opportunities. Rising capital formation and efficiency will create rapid productivity and real wage gains, the famous supply-side effects.

THE U.S. ECONOMY: FAR WEAKER THAN IT APPEARS.

Never before have the central banks of West Germany, the United States, the U.K, and Japan faced such contrasting policy challenges. On the one hand, the Bundesbank confronts a booming economy and an imminent German economic and monetary unification. Contrastingly, in the United States, there is a melange of a sluggish economy, persistent and unacceptably high inflation, a fraying financial system and a heavy dependence on capital inflows. The Bank of Japan, on the other hand, has to cope with grossly inflated asset prices and excessive capital outflows weakening the yen which, in turn, threaten to accelerate price inflation.

Beliefs Hold Sway Over Facts. In the case of the United States, one thing has not changed. That is the markets' belief in a "soft landing". Yet, the adherence to this view has not excluded certain changes in the expectations about monetary policy. Late last year and early this year, the U.S. economy was seen as rather soft, therefore compelling the Fed to ease further. The dollar duly drifted downward.

The important new points for the recent reversal in the dollar is that the second half of February brought a string of better-than-expected economic data. That was coupled with unfriendly inflation news and various declarations by Fed Chairman Greenspan in the mold of his statement that *"from these data, one can infer the beginnings of a modest firming in economic activity."* All taken together, these developments shattered former dreams of lower interest rates. In fact, there was even speculation that the Fed may even have to tighten. Promptly, the dollar rallied, and so did sympathetic U.S. stock and bond markets.

Given our earlier convictions that the U.S. economy is dangerously weak and vulnerable, we have again carefully scrutinized recent US. economic data as well as Greenspan's testimonials. It would shock us if Greenspan meant what he said about evidence of a bottoming out of the economy. Our reading is very different.

Economic Interpretations Fraught With Distortions. In the first place, it has to be realized that the U.S. economic statistics of the last two-to-three months have been grossly distorted by an accumulation of unusual one-time events. The more important of these included Hurricane Hugo, the California earthquake, a record-cold December then followed by a record-warm January, a long strike at Boeing, another one at AT&T, and last but not least, temporarily aggressive sales promotions by the three big auto-makers.

On the face of recent economic data, housing is booming, and consumer spending and exports are strong. True, there were also some extremely weak spots, like collapsing new factory orders and a sharp decline in industrial production, but while the strong data are generally hailed as "healthy gains", weak statistics have been brushed aside as temporary aberrations.

On March 1, the Financial Times carried the following headline on its front page: "*Greenspan cheered by expansion of GNP*." What had apparently cheered Mr. Greenspan was an upward revision of U.S. GNP growth in the fourth quarter from \$5.2 billion to \$9.5 billion, or from an 0.5% annual rate to 0.9%. The main source of the revision was higher net exports.

As a matter of fact, this news didn't only cheer Mr. Greenspan. The dollar and Dow Jones Industrials voted their approvals as well. In reality, the entire GNP growth during the fourth quarter was based on two patently phoney items. One was an extraordinary surge in home heating of \$6 billion caused by the extremely cold weather. . . in other words, hot air in the true sense. The other was the result of large currency gains on US foreign investments, reflecting the dollar's fall against the European currencies.

The point is that the United States - the only country in the world to do so - treats such currency gains as *income* and therefore counts them as contributing to GNP growth. The same phenomenon already buttressed third quarter GNP growth. Of a \$9.4 billion decrease in the current-account deficit, \$7.6 billion was attributed to such paper currency gains. Since very, very few American economists are aware of this statistical quirk, it becomes understandable why so many uninformed comments about U.S. trade improvement have arisen.

Here is another amusing detail. On January 29, 1990, the U.S. Department of Commerce (USDC) announced that December personal consumption expenditures had increased 0.8% in real terms after having declined in October and November. At once, everybody proclaimed that the consumer was resuming his spending. However, 40% of that spending increase was due to the cold-weather related rise in home heating. Simultaneously, of course, the burst in energy demand boosted December's industrial production.

In February, the USDC announced a 1.2% decline in industrial production, the steepest drop in nearly four years. Markets reacted with a yawn, on the argument that the declines were mainly the result of a stock adjustment in the auto industry which was already reputed to be bouncing out of its doldrums. While the auto industry was the hardest-hit, in reality the decline was broadly based, leaving industrial production only 0.1% higher than a year ago.

Later, on February 27th, the USDC followed with an announcement of a record drop in orders for durable goods of 10.5%, the steepest decline ever since the series was first tabulated 32 years ago. Again, the markets shrugged. Mr. Greenspan and others hurried to explain that the decline was exaggerated by volatile orders in autos and aircraft.

It's true, of course, that the order patterns of these two industries have proven extremely volatile over the past few years. What's amusing is to note that talk of volatility is only limited to the down-side and never the upside. Just a few weeks ago, the Fed Chairman, in his recent testimonials to Congress made the statement: "*Orders for non-defense capital goods received in November and December a bounce-back from the decline that had occurred in the third quarter.*"

What Mr. Greenspan euphemistically labelled as a "bounce-back in non-defense capital goods orders" was really another one of the many multi-billion chunks of aircraft orders from airlines and aircraft leasing companies. This lumpy source of capital goods orders all throughout last year raised unfilled aircraft backlogs from \$92.1 billion to \$142.9 billion. Since recent orders in this category will only impact actual production years later, Mr.

Greenspan's remark was utterly misleading. This flood of aircraft orders, in reality, has served to mask order weakness elsewhere. Aircraft is the only industry that's holding up the overall level of unfilled orders. Elsewhere, the backlog is shrinking rapidly.

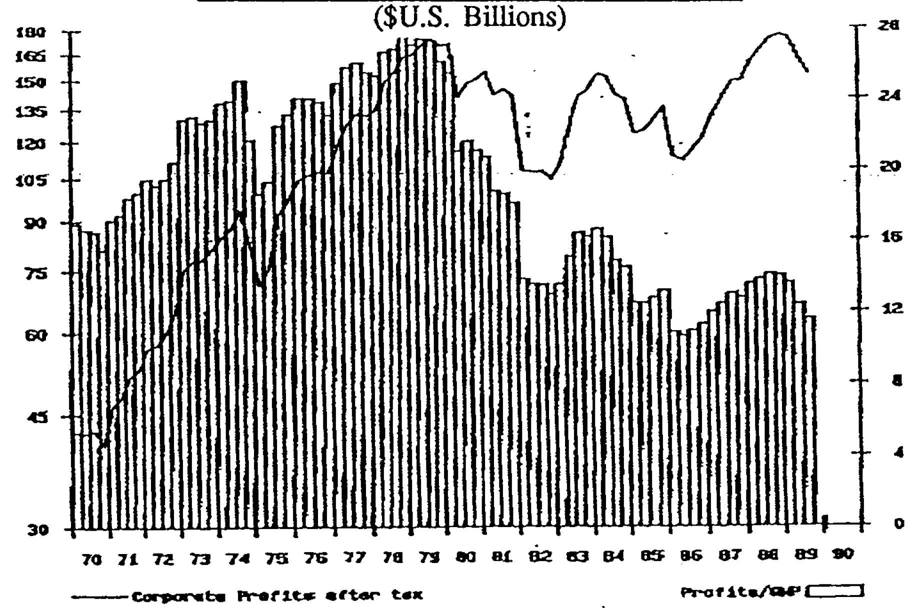
There is a simple way to get around these month-to-month distortions and that is to make comparisons against year-ago levels. From that perspective, durable goods order were in fact down by 8.3% in January. Non-defense capital goods orders fell 5.6% and total orders declined by 3.6% on the same basis. Unmistakably, there is an accelerating and cumulative down-turn in new orders. Nobody should know that better than Mr. Greenspan.

There are other distortions in recent economic statistics that were due to seasonal adjustment factors. That was particularly evident in employment data, housing starts and retail sales. Suffice it to say that a weak economy - in fact an economy that continues to weaken - persists and lurks underneath the mess of all these statistics.

Looking through the erratic ups and downs of the monthly data, the trends are absolutely clear. Spending by consumers, businesses and governments as well as employment growth have all slowed sharply right across the board. Nothing on the horizon suggests that recent trends are about to change. The slow-down in domestic demand may at least have a beneficial effect on the trade deficit. But export growth, too, has been relatively flat since March 1989 at a level of $30-31 billion.

Economy Hampered By Deteriorating Financial Structure. At the same time, corporations in all sectors - manufacturing, retail trade, services - are caught between rising labour costs, sluggish demand and unprecedented debt and interest-rate burdens. Plunging profits are perhaps the economy's biggest risk. Operating profits of non-financial companies plummeted by 23% between the fourth quarters of 1988 and 1989. Even before the economy has entered a recession, profit margins are at their lowest levels of the whole post-war period.

U.S. CORPORATE PROFITS AND GNP
($U.S. Billions)



Source: SMH-Research

On top of all the economic weakness are the splintering strains of the disasters in the financial system. The junk bond crisis, the S&L crisis, and a momentum-gaining real-estate debacle hitting the banking system, all conspire to constrain credit.

Given the plainly visible spectre of demand problems in every sector, an embedded inflation, a profit squeeze, record low credit expansion, and serious financial strains, one needs a good measure of blindness and complacency to believe that the risk of a recession is diminishing. The economy is indeed hovering on the brink of recession, and given the financial instabilities, the risks for a prolonged and deep downturn are the highest of the entire post-war period. What heightens the gravity of the situation is that the Fed's latitude has never been so restrained as today.

Never-the-less, whenever the signs of accelerating weakness in the U.S. economy surface to become obvious to all, the Fed will have no choice but to ease aggressively. However, there is little chance that the economy will respond given the hyper-sensitive condition of the financial structure. The only certain and direct support for the U.S. economy would be a falling dollar. That would threaten a currency crisis, however. If the expectations for a lower dollar gain momentum, the Fed would again have to raise interest rates sooner or later. Considering the robustness of the German and Japanese economies, we have to conclude the potential for a dollar crisis is the highest it's ever been.

Just when could such a scenario begin to unfold? Quite realistically, these events could happen anytime this year.

JAPAN IS IN TROUBLE

Surely, one of the greatest surprises for most observers has been the prolonged weakness of the Japanese yen which has been followed by sharp declines in Japanese stock and bond prices. All of these developments have caused widespread consternation because the consensus regarded Japan as an economic and financial super-power. Recent events just didn't gel with the popularly accepted legend that Japan's Ministry of Finance is inhabited by geniuses who usually have everything under finely-orchestrated control.

In our last letter, we expressed our radical dissent with the wide-spread admiration of Japan. We made a critical point that few people are aware of - that Japan's leading role in the world's financial markets is not at all based on the strength of domestic savings. The truth is that most of Japan's large purchases of foreign assets - mostly U.S. real estate, factories, stocks and bonds - have been made with money that was borrowed abroad, mainly in the Euro bond and money markets. Last year, Japan's current account surplus of $57 billion was matched by long-term capital outflows of $170 billion. Basically, foreign purchases of foreign real assets were three times higher than the surplus.

Japan: The Great Stabiliser? As explained in the last letter, Japan has used - or more correctly said - abused their high credit rating and their correspondingly huge borrowing capacity to exploit international interest rate differentials. Overwhelming, the Japanese have borrowed in Europe and bought in the U.S..

At the end of last year, Japan's gross external assets totalled around $1.7 trillion. However, the net position was only $350 billion after deducting foreign liabilities. That's not so much higher that Germany's net international position which amounts to $270 billion. It doesn't need to be said that German banks and investors keep a much lower profile.

Every country has simultaneous outflows and inflows. That's normal. However, there are some spectacular and important differences between Germany and Japan. The following table shows the figures.

FOREIGN ASSETS AND LIABILITIES
(IN BILLIONS $US)

	GERMANY			JAPAN		
	ASSETS	LIABILITIES	NET	ASSETS	LIABILITIES	NET
1984	252	201	52	341	267	74
1985	346	289	58	438	308	130
1986	497	404	93	727	547	180
1987	655	495	159	1072	831	241
1988	682	476	206	1469	1178	292

The facts clearly underline the point we made: that most of the foreign assets purchased by the Japanese have been made with money that was borrowed abroad. Between the end of 1985 and 1988, Japan's foreign assets increased by $1.031 trillion. Only $162 billion of this increase was covered by the current account surplus. The other $870 billion was covered by foreign borrowing. It's worth noting that this foreign borrowing spree began to run wild after 1985. In the five years prior between 1985 to 1985, Japanese foreign liabilities had risen only $160 billion.

This brings us to a crucial question concerning the nature of huge Japanese capital inflows as reflected by these soaring foreign liabilities. Recently, a study by Morgan Guaranty Trust Company (World Financial Markets, November 10) attributed these cross-flows to the fact that "*Japanese institutions, especially banks, have become major international intermediaries, taking funds from non-residents and re-lending and investing overseas.*"

In our view, that's far too friendly of an interpretation. Neither is the yen a truly international currency nor is Tokyo a true international intermediary as the sterling once was and as the dollar and the D-mark are now. International intermediation and international speculation are two different things.

If it were left to the markets, Japan - with its low interest rates and inflated assets prices - would have very little capital inflows. To get large capital inflows, Japanese banks and institution have to borrow in international markets on their own initiative. This is largely done in currencies other than the yen and the funds are then employed to buy high-yielding assets, usually in the United States.

That has nothing to do with "international intermediation" but everything with international speculation. The fundamental contrast to the international function and role of the D-mark is obvious. Long-term capital inflows into Germany occur largely on the discretionary initiative of foreign investors and central banks that want to hold DM-assets.

Japan's reckless international speculation has had it counterpart in reckless domestic speculation in the stock and real estate markets. This speculative activity has been fuelled by

years of an over-expansive monetary policy. Japan's money supply has been growing consistently at a rate of 10% in recent years and has even accelerated recently.

The other factor behind this rampant speculation is that banks and corporations have sought to make up for deteriorating profits from current operations. The word for it is "*zaitech*" (financial engineering). Two out of every five public companies make as much money form speculating in stock and real estate markets as from manufacturing.

More and more, it seems to us that these developments are fast careening out of control. It is often said that the government and the central bank want to deflate the speculative bubble very gradually. But their hesitancy and ambiguity have caused a loss of confidence instead.

The danger now is that the longer they hesitate, the higher the price - that is the stronger the necessary rise in interest rates to restore confidence. In the end, only "hara-kiri" may satisfy the international markets.

SUMMARY CONCLUSIONS

From the framework of international money flows, the first decisive point in East European developments is that German savings will be diverted from other countries to finance investment in underdeveloped East Germany and East Europe. Europe's capital demands are going to rise sharply. From that perspective, higher interest rates are justified.

Paradoxically, financial markets believe that a clamour for limited world savings and firming pressure on interest rates will be rougher on those countries with savings surpluses than those lumbered with inadequate savings. To believe that one would have to be economically illiterate. The holders of savings surpluses retain the option to lend while borrowers have little flexibility but to borrow more.

The recent strength of the U.S. dollar is attributable to three factors: first, jitters about Japan; second, unfounded inflation worries related to East-West German unification; and third, "perceived improvements" in the U.S. economic statistics. All of these dynamics carry the carry the seeds of dollar weakness.

We continue to stress that the fortunes of the U.S. will change dramatically when the weakness in the U.S economy becomes more obvious and less prone to optimistic explanations. The risk of a dollar crisis is the greater than at any time in the post-war period.

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